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## Trade Secret Holding Companies: A Structural Solution To A Sarbanes-Oxley Requirement

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Section 302 of Sarbanes-Oxley requires the CEO and CFO of public companies to certify that their annual and quarterly reports do not contain any untrue or misleading statements of material fact or material omissions. They must also certify that the financial information in the report fairly presents the financial condition of the company. As valuable assets that materially affect the financial condition of the company, trade secrets fall under Section 302.

In addition, Section 404 requires companies to document and certify the scope, adequacy and effectiveness of the internal control structure and procedures for financial reporting and controls, which should include internal controls and procedures for handling valuable trade secret assets. Finally, Section 906 imposes civil and criminal penalties for violations of Sarbanes-Oxley. Shareholder suits for non-compliance also loom on the horizon, and may well target officers and directors personally.

Yet trade secrets are among the most difficult assets of the company to quantify, or even to identify. The Seventh Circuit Court of Appeals recently noted that the existence of a trade secret is one of the most elusive and difficult concepts in the law to define. Faced with this challenge, U.S. corporations often ignore or sweep trade secret assets under the rug. They only surface, if at all, when a key employee leaves the company and a trade secret misappropriation lawsuit is filed. This state of affairs is no longer viable in view of the SOX requirements.

The existing atmosphere in most U.S. corporations is partially to blame for the sorry state of trade secret assets. The identification and protection of trade secret assets takes time, effort and money. Budgets are nonexistent or insufficient for these tasks. Too often trade secret protection is viewed as an administrative expense rather than an operational necessity. The result is that the company's trade secret assets are often left unprotected to the economic detriment of the company's shareholders.

\* Importance of Trade Secrets \*

Subtract your company's book value from its market capitalization, and in our modern information-oriented economy you will find that much of your company's value cannot be accounted for. Some of it is goodwill, branding, trademarks and patents, but the bulk of this unaccounted economic value is the company's trade secrets.

Trade secrets are differentiators. By definition, the company's trade secrets are comprised of information unknown to competitors that allows the company to derive competitive advantages in the marketplace. Trade secrets differentiate the company and its products from competitors, and therein lies their economic value. This economic value is perceived by the equity markets and reflected in the company's stock price

The law requires reasonable measures under the circumstances to protect trade secrets. Given the often enormous difference between the company's book value and actual marketplace capitalization, it should be apparent that trade secret assets must be identified and protected. Yet, today, many corporations do not document the existence and location of trade secret assets.

## \* Structural Bias \*

One thing that places trade secrets at risk is the structural bias that account for what is easy rather than for what is important. The machine on the production floor, the fork lift, the computer you sit in front of and the desk it sits upon, the very chair you are sitting in—all have property tags. They are logged and tracked not because they are valuable, but because they are tangible. Yet there is no piece of furniture, no vehicle, no machine that is worth a fraction of your most valuable trade secret.

Even the question "What is your most valuable trade secret?" poses a conundrum. There is no trade secret control function within the corporation, no trade secret identification procedures, no trade secret classification procedures, and, of course, no trade secret valuations

Without a concrete asset to account for, U.S. companies have simply ignored trade secret assets. How many trade secrets does the company have? How much time, money and effort will be required to identify, classify and protect trade secret assets? Most U.S. corporations cannot answer these basic questions.

## \* A Trade Secret Holding Company \*

The formation of a holding company for intangible assets has a lot of merit. In recent years, U.S. companies have begun to set up subsidiaries to license patent assets. Others advocate this approach for trademarks. Patents and trademarks are well defined by the application process, however, and thus easier to deal with by traditional methods. It is the inchoate mass of trade secret assets for which the holding company business model is particularly well suited.

In this model, the corporation sets up a wholly owned subsidiary for its trade secret assets and then transfers legal title to the company's entire portfolio of trade secrets assets to the newly established trade secret holding company. Under current IRS rules and regulations, this is not a taxable event. The corporation then enters into an exclusive license with the trade secret holding company to use the trade secret assets. This results in a number of business advantages.

First, the formation of a trade secret holding company with attendant reporting obligations to the parent can be easily tailored to comply with the Section 302 reporting and Section 404 process requirements under Sarbanes-Oxley with regard to trade secrets.

Second, a trade secret holding company need not be incorporated in the same state as the parent. By choosing a low-tax state for the trade secret holding company, the parent company can deduct the royalties as expenses in the high-tax state while enjoying tax savings on the royalty income received by the trade secret holding company in the low-tax state.

Third, the income earned from royalties by the trade secret holding company can be loaned back to the parent corporation. Interest on such loans will be treated as a business expense in the parent company's home state, resulting in an increase in net revenues to the parent corporation.

Fourth, the trade secret assets of the trade secret holding company, once accounted for, can now serve as collateral for loans or such assets can be licensed to third parties. Once again, the income from these activities can be loaned back to the parent company in the high-tax state, resulting in the same advantages outlined above.

Fifth, the income derived from the royalties and other income-producing activities of the trade secret holding company now provides the revenue source necessary to set up the dynamic systems required for the identification, classification, protection and valuation of trade secret assets.

#### \* An Accounting System for Trade Secret Assets \*

While all of the advantages discussed above are in themselves sufficient reason to pursue the business model of a trade secrets holding company, the greatest advantage may lie in the structural advantages that a trade secret holding company provides for the development and implementation of a trade secret accounting system.

The rules are well established for determining appropriate royalty rates for income-producing assets. There are also well-established rules for determining the costs of maintaining such assets. The existence of a trade secret holding company now provides the opportunity to apply these same principles to determine appropriate royalty rates and commensurate maintenance and accounting costs for trade secret assets.

As previously noted, the difference between the company's book value and its market capitalization defines the upper limit of the total value of the company's trade secret portfolio. Ratios can be developed to determine the respective values of brands, trademarks and other good will, and such ratios will vary from company to company. Applying these ratios, a reliable estimate of the total economic value of the trade secret portfolio can then be determined.

Based on the total value of the trade secret portfolio, appropriate royalty rates can be determined. Likewise, appropriate budgets for the maintenance and accounting of trade secret assets can be determined. The trade secret holding company's charter will be to maintain and account for these assets, and it will have the revenue stream necessary to both justify and finance these necessary operations for trade secret assets.

**\* A Profit Center, Not A Cost Center \***

At this point it is appropriate to ask if a holding company merely adds another layer of bureaucracy to the task of identification, protection and valuation of trade secret assets. Does the trade secret holding company actually constitute a solution? Cannot these same tasks be handled by the parent company despite the advantages outlined above? Could these same processes be performed within the parent company?

Perhaps there is room for debate, but the record to date is clear. U.S. companies have a dismal track record when it comes to the protection, management and valuation of trade secret assets. Even well-intentioned efforts are short-lived when management attention moves on to other issues. Resources dissipate, budgets are cut, staff is laid off or reassigned under the twin pressures of staff and budget constraints. It is impossible in the U.S. corporate environment to develop long-term plans if trade secrets programs are considered a corporate "expense" and not a corporate "asset."

The trade secret holding company provides a structural solution and ensures compliance with the requirements of Sarbanes-Oxley because (1) it is a profit center, not a cost center, (2) it has a revenue stream, with both an obligation to protect that revenue stream and the resources to do so, (3) it results in a dedicated and experienced staff focused on trade secret assets that cannot easily be redirected to other projects in the parent corporation and (4) it reports through a direct line of communication with top management and the Board of Directors as required by Sarbanes-Oxley for this important asset class.

**\* Conclusion \***

A wholly-owned subsidiary for trade secret assets provides the opportunity to solve longstanding problems relating to the proper management and accounting of trade secret assets. The establishment of a "trade secret holding company" will ensure compliance with the requirements of



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Sarbanes-Oxley while at the same time providing other important financial benefits to U.S. corporations.

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